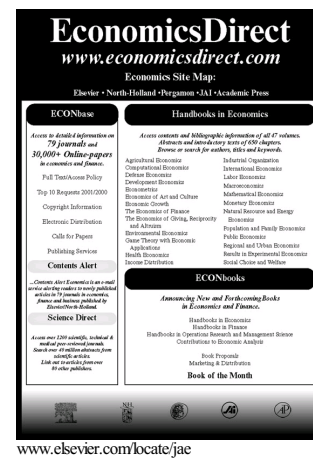


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The relation between earnings-based measures in firm debt contracts and CEO pay sensitivity to earnings

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The relation between earnings-based measures in firm debt contracts and CEO pay sensitivity to earnings

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ABSTRACT: I investigate how implicit incentives provided by earnings-based debt covenants affect the structure of CEO compensation contracts. This provides a new and unique view of how the CEO's incentives are shaped by not only his compensation contract but also debt contracts. I find when debt contracts contain an earnings-based covenant, the CEO's pay sensitivity to earnings is muted. Additionally, I find some evidence that pay sensitivity to earnings varies with earnings-based covenant slack. This study provides evidence consistent with shareholders rebalancing the CEO's earnings incentives in the presence of earnings-based covenants, thereby tilting incentives away from earnings performance.

Keywords: Executive compensation; debt contracts; covenants; agency costs

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